

## **FITCH RATES NASHUA NH, GO PENNICHUCK ACQUISITION BONDS 'AAA'; OUTLOOK STABLE**

Fitch Ratings-New York-06 January 2012: Fitch Ratings has assigned the following rating to the City of Nashua, NH's (the city) general obligation (GO) bonds:

--\$150 million GO taxable Pennichuck Corporation acquisition bonds 'AAA'.

Proceeds will be used to acquire the privately owned water systems serving the city and several surrounding communities through a stock acquisition of the current owner of the utility, Pennichuck Corporation (Pennichuck).

The bonds are scheduled to price on Jan. 11, 2012 via negotiation.

In addition, Fitch affirms the following ratings:

--\$0.9 million outstanding GO bonds, series 1999, at 'AAA';

--\$5.4 million outstanding GO capital improvement bonds, series 2010, at 'AAA';

--\$13.5 million GO capital improvement bonds, series 2011 at 'AAA'.

The Rating Outlook is Stable.

### **SECURITY**

The bonds are an unlimited tax general obligation of the city.

### **KEY RATING DRIVERS**

**ACQUISITION BONDS SUPPORTED BY USER RATES:** It is Fitch's expectation that acquisition bond debt service will be supported by utility revenues, but ultimately the bonds constitute a general obligation of the city, backed by its unlimited taxing power.

**PENNICHUCK RATE METHODOLOGY APPROVED:** A ratemaking structure expected to provide sufficient revenues to support the debt service on the bonds has been approved by the New Hampshire Public Utility Commission (the PUC).

**DIVERSE AND EXPANDING ECONOMIC BASE:** The city's economy continues to see growth and development and is a key center within the state for business and government.

**STRONG FINANCIAL MANAGEMENT:** City management have made appropriate spending cuts in order to keep tax rates under control, address increasing employee costs and maintain fund balances within prudent policy levels.

**STRONG RESERVE FUND LEVELS:** Even with a slight decline in fiscal 2011, reserve funds remain healthy and provide financial flexibility if pressures should arise.

**ABOVE-AVERAGE SOCIOECONOMIC FACTORS:** The local economy is diverse with good wealth indicators and below-average unemployment rates.

**MANAGEABLE DEBT BURDEN:** The city's debt burden including this issuance is moderate to high but taking into account the self-supporting nature of the acquisition bonds and state grants for school debt, debt levels are low.

**DIVERSIFIED TAX BASE:** The top ten taxpayers represent a modest 8% of the taxbase, and the city's acquisition of the common stock of Pennichuck (the second largest taxpayer) does not exempt Pennichuck from future property tax payments.

## CREDIT PROFILE

In November 2010, the city and Pennichuck, a private water company that provides water service to the city, entered into an Agreement and Plan of Merger to acquire the outstanding common stock of Pennichuck for approximately \$138 million. The agreement settles a longstanding eminent domain dispute between the city and Pennichuck which commenced in 2003. The city's main objective for the acquisition of Pennichuck is to secure and protect their critical water resources for future generations.

The New Hampshire State Legislature enacted legislation in 2007 authorizing the city to acquire the shares of Pennichuck and its subsidiaries subject to a finding by the PUC that the acquisition was in the public interest. The PUC issued Order No. 25,292 (the order) in November 2011 approving the acquisition, adopting the provisions and requirements of the settlement agreement entered into between the city and Pennichuck, and concluding that the acquisition was in the public interest. The order became final and non-appealable on Dec. 23, 2011 (the period for filing a motion for rehearing having expired).

Pennichuck's three regulated water utility subsidiaries - Pennichuck Water Works, Inc. (PWW), Pittsfield Aqueduct Company, Inc. and Pennichuck East Utility, Inc. - will each continue to operate in their current corporate forms. Under the terms of the settlement agreement, approved by the PUC, each of these regulated entities is required to request any future rate adjustments using a modified ratemaking structure set forth in the settlement agreement which includes a revenue requirement specifically structured to cover each utility's operations and apportioned share of the city's acquisition bond debt service.

Fitch believes that this rate structure, which assumes a lower rate of return to share holders compared to prior years, is reasonable and allows for sufficient rate setting to service the acquisition bonds. The acquisition bonds are ultimately secured by the unlimited taxing authority of the city should revenues from Pennichuck be insufficient and such pledge coupled with the assumption that the bonds will be fully or substantially supported by utility revenue, serve as the basis for the current rating.

The distributions of revenues from Pennichuck to the city will be performed via a note entered into between Pennichuck and the city for approximately \$120 million with principal and interest (fixed at a rate exceeding the bond rate) payable in monthly installments over 30 years (coinciding with the term of the proposed bonds). The remaining amount of revenue to support bond debt service will be made via dividend payments, expected to be declared monthly, from Pennichuck to the city based on the \$30 million equity contribution funded from proceeds to be paid by the city to Pennichuck as part of the acquisition. Such distributions will be held by the city in a separate revenue fund.

The transaction provides for the funding of a \$5 million rate stabilization fund from bond proceeds, which will be held by PWW and is not pledged to bondholders. The sizing of this fund was based on a 2 1/2 times actual worst case year results. The rate stabilization fund is available to be drawn to meet the note and dividend payments to the city if, for example, very wet weather conditions should occur and revenues are inadequate to cover expenses (including debt service payments). The PUC approved settlement agreement provides for a three-year replenishment (make-whole) of the rate stabilization fund through filing of a new rate case if the fund is drawn on.

Pennichuck and its subsidiaries provide water service to a total of 34,000 customers in the Nashua area. Nashua represents 66% of the total customers followed by Litchfield (5.4%), Londonderry (5.4%) and Amherst (3.5%).

The city is located on the southern border of the state of New Hampshire, 34 miles northwest of Boston. The local economy serves as a regional hub for retail with two very large retail shopping malls which provide tax-free shopping for New Englanders. The city has emerged as a regional center for medical services and is home to a diverse group of international companies including Oracle, Dell, Fidelity Investments, and BAE Systems. The city has two industrial parks and is experiencing continued new development. The city's demographics are positive, with

unemployment levels having declined to 5.6% as of October 2011 from 6.0% in October 2010. Wealth levels exceed both state and national averages. The city's population of 86,494 has remained relatively flat since 2000.

A recent revaluation in 2009 resulted in a 10% decline in assessed value (AV) for fiscal 2010, reflecting losses in the residential and commercial sectors. The decline in AV does not affect the city's ability to raise its tax rate, but there is a cap on total appropriations, which cannot exceed the three-year average of the Northeast Region CPI percentage over the previous year's budget, in accordance with the voter-approved Budget Control Charter Amendment passed in 1993. An exemption of this appropriation limit is permitted for all capital expenditures and bonded debt with a two-thirds vote from the city's board of alderman. Top 10 taxpayer concentration is modest at 8%.

The city has managed recent revenue declines and rising employee costs through prudent cost cutting measures and achievement of successful negotiations with its bargaining units. Property taxes, which represent 72% of general fund revenues, have been increased responsibly, and below the budget cap which was 3.4%, 2.2% and 2% of the prior year's levy in fiscal 2010, 2011 and 2012, respectively.

For fiscal 2011, the city budget increased by 2.1% compared to 2.3% in fiscal 2010. The city's general fund experienced a \$4 million positive budget variance in expenditures, but budgeted revenues came in less than anticipated by \$1.5 million due to continued underperformance of local revenues and investment income. The city had appropriated \$4.3 million of general fund reserves used to balance the budget (which is its customary practice) and ended the year with a \$4.4 million deficit after transfers.

The city's undesignated general fund balance declined by \$1 million to \$25.6 million which represents approximately 11% of budgeted spending and is in excess of the city's 10% undesignated fund balance policy. The city implemented GASB 54 reporting rules in fiscal 2010 and reported a total unreserved fund balance (committed, assigned and unassigned) of \$45.3 million for fiscal 2011, or a strong 19% of general fund spending, compared to \$49.8 million in fiscal 2010.

The city's fiscal 2012 budget increased by only 1.7% over 2011, in large part due to a 3% decrease in all departmental operating budgets (excluding school and technology). The \$227 million budget was under the spending cap by \$978,669. Notable expenditure increases were incurred for pensions (up 20%), due mostly to the state's elimination of the employer contribution subsidy, and increasing employee healthcare costs. The city has worked with its insurance carriers to reduce premiums and successfully negotiated healthcare and salary concessions with the bulk of its workforce. The city continues to maintain contributions to its capital reserve funds to support equipment and fleet replacements and other city and school improvements.

The city's debt ratios (net of estimated state school grant reimbursements and payments from Pennichuck), remain low at 1.7% of fiscal 2011 market value and \$1,666 per capita. The city typically issues \$5 million-\$10 million in bonds to support capital needs every two years. The issuance of the acquisition bonds are not subject to the limit on GO borrowing by the city pursuant to the State Legislature enactment of an amendment to the 2007 legislation authorizing the city to issue general obligation bonds to finance the acquisition.

The city's non-public works employees participate in the state's pension system, and the city made an \$11.8 million contribution in fiscal 2011, 100% of its annual required contribution (ARC). As a result of the state's elimination of its pension cost-sharing arrangement in fiscal 2012 (compared to 25% state funding in 2011), the city is budgeting \$14.6 million in state plan pension costs. Public works employees participate in a city-managed single-employer system. The fiscal 2011 ARC was \$755,000, which the city paid in full. Combined contributions for the city represented a manageable 6.8% of the fiscal 2012 general fund budget. The city plan is 83% funded, and the unfunded liability is \$6.5 million as of June 30, 2010. For fiscal 2011, the city's annual other post-employment benefits cost was \$5.6 million, and the city contributed 41% of that amount. The unfunded liability was \$42 million as of June 30, 2010, the most recent valuation available.

Contact:

Primary Analyst  
Kevin Dolan  
Director  
+1-212-908-0538  
Fitch, Inc.  
One State Street Plaza  
New York, NY 10004

Secondary Analyst  
Andrew DeStefano  
Director  
+1-212-908-0284

Committee Chairperson  
Michael Rinaldi  
Senior Director  
+1-212-908-0833

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email: sandro.scenga@fitchratings.com.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, S&P/Case-Shiller Home Price Index, IHS Global Insight, Zillow.com, National Association of Realtors, and C.W. Downer & Co., transaction financial advisor.

Applicable Criteria and Related Research:

--'Tax-Supported Rating Criteria' (Aug. 15, 2011);

--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 15, 2011).

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Tax-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=648898](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648898)

U.S. Local Government Tax-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=648842](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648842)

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